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November 9, 1993

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

92-266

Re: Notification of Permitted Written Ex Parte Presentation in MM Docket Nos. 92-266 & 93-215

Dear Mr. Caton:

ParCable, Inc., by its attorneys and pursuant to Section 1.1206(a)(1) of the Commission's rules, hereby submits two copies of a permitted written *ex parte* presentation to Commission officials regarding MM Docket Nos. 96-266 & 93-215.

Kindly direct any questions regarding this matter to the undersigned.

Respectfully submitted,

Donna C. Gregg

Donna C. Gregg

DCG/ddl
Attachment

cc: John Winston
Bill Johnson
Pat Donovan
Maureen O'Connell
Byron Marchant
John Hollar

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November 9, 1993

Mr. Patrick J. Donovan
Federal Communications Commission
Office of Division Chief
Cable Services Division
2033 M Street, N.W., Room 918B
Washington, DC 20554

Re: MM Docket Nos. 92-266 and 93-215

Dear Pat:

We are forwarding herewith some additional materials from Mr. Michael Grannon of ParCable, Inc. on the tax aspects of cable rate regulation discussed at our meeting on October 19, 1993. Mr. Grannon is available at (212) 541-6793 if you have further questions concerning the enclosed.

For your information, two copies of this letter and enclosures have been sent to the Secretary for association with MM Docket Nos. 92-266 and 93-215.

Sincerely yours,

Donna C. Gregg

Donna C. Gregg

DCG/ddl
Enclosure

cc with: FCC Secretary (Docket Nos. 92-266 and 93-215)
John Winston
Bill Johnson
Maureen O'Connell
Byron Marchant
John Hollar

Notes For Further Discussions With FCC

Regarding Income Tax Allowance

For Subchapter S Corporations, Partnerships and

Sole Proprietorships

* Three Separate Issues Are Involved In FCC's Considerations:

I. Treatment of Taxes That Arise From Operation of Cable Systems;

II. Rate To Subscribers;

III. Total After-Tax Return To Shareholders.

I. Treatment of Taxes That Arise From Operation of Cable Systems

* FCC: "provision for income taxes is made" "to allow" "business entity" "a fair after-tax return on its investment"

* How do income tax liabilities arise and how are income taxes paid?

* With both C and S Corp's, operations create income on which an income tax liability is incurred. The form of ownership will not impact the amount of income subject to taxes. The income is never "exempt" from taxes.

* A C Corp puts its revenues and expenses in its IRS corporate income tax Form 1120 and pays the tax due as a result of the resulting net taxable income at the corporate tax rate

* An S Corp prepares a Schedule K showing the same net taxable income amount and sends this form to the IRS and the shareholders

* An S Corp also prepares a Schedule K1 showing each shareholder's allocation of the net taxable income shown on Schedule K and sends this form also to the IRS and the shareholders

* The S Corp shareholders include their respective allocations of the S Corp's net taxable income on their IRS Form 1040's on the Schedule E line

* The S Corp pays the amount of the tax due as a result of its operations to the shareholders, who in turn pay the IRS

these taxes at the personal income tax rate

* The only difference between these situations **<u>for the "business entity"</u>** is that the top personal tax rate is now 39.6% and the top corporate rate is 35%

* At least up to the corporate rate, the exact same tax liability is incurred by **<u>the "business entity"</u>** on the exact same net taxable income

* Thus, in reality, income taxes arising from the operations of the "business entity" are taxes on corporate earnings where the burden of ultimate payment to the IRS is transferred to the individual shareholder (at the higher individual marginal tax rate)

* To the extent that a S corporation can not have subscriber rates that reflect an allocation for income tax liability, **<u>its "after-tax return on its investment" will be reduced by the amount of the taxes</u>** - thwarting the FCC's stated goals

* If its subscriber rates never include an allowance for income taxes, a S Corp will **<u>never</u>** be able to earn a "fair after-tax return on its investment"

* Thus a S Corp will be denied the funds it needs to continue to expand the system, add programming or make the other capital expenditures necessary to take advantage of all the much talked about advances in technology - all to the detriment of its subscribers

* All cases found by Wiley, Rein & Fielding support our position - none support the FCC's position

* The present rule of not providing an allowance for income taxes for S Corp's, partnerships and sole proprietorships creates a disproportionately large burden on small businesses, since these are the very forms of ownership favored by small businesses

II. Rate To Subscribers

* Providing S Corporations an allowance for income taxes (at least up to the corporate rate) merely puts all subscriber rates on an equal basis

* Subscribers would pay the same rate regardless of the ownership structure of the "business entity" - thus no subscriber would be favored or discriminated against because of the ownership structure of the "business entity"

* Attached Charts A through E show effect on rates to subscribers of providing and not providing an allowance for income taxes as well as the effect on the "after-tax return on its investment" to the "business entity" in each such situation

* All examples assume each "business entity" has exactly the same investment, the same "fair after-tax return on its investment" and the same expense structure (other that income taxes)

* The charts use the same logic as is used in the instructions for Schedules A and C and as is contained in the proposed rules for cost of service showings. The difference between the instructions for the Schedules and the proposed cost of service methodology is that the Schedules require the calculation of what theoretical income taxes would be on the theoretical "fair after-tax return on ... investment" by "grossing-up" the "return" (i.e. by dividing by one minus the tax rate) and the proposed cost of service rules propose "taxes incurred in the provision of regulated cable services", without elaborating on the method of their calculation.

(It is important to note that the calculation of income taxes for Schedules A and C and presumably for cost of service showings involves theoretical, not actual, results. The use of the theoretical "return" concept in Schedules A and C, on which the income tax allocation is based, and the regulation of the way certain revenues (i.e. regulated services only included) and costs (such as depreciation) may be included or not included in cost of service showings will ensure that the allocation of income taxes for rate setting purposes will very rarely, if ever, be equal to the actual income tax liability on net taxable income for any "business entity" in any given year.

This does not present a problem, in itself, because any marginal net pre-tax income, as defined for rate regulation purposes, does create a theoretical marginal income tax liability. However, any attempt to combine the concepts of actual income taxes paid and regulated allocations of income taxes on regulation determined "returns" or regulation defined net pre-tax income will inevitably result in inconsistent and unequal treatment for "business entities" and subscribers alike.)

* Chart A shows how the rate for subscribers to C Corp services would be determined using present and proposed FCC rules

* Chart B shows that, if the allowed marginal income tax rate is limited to the corporate rate, subscriber rates would be the same for C Corp and S Corp subscribers and each "business entity" would earn a "fair after-tax return on its investment" (except for the non-allowance for the difference between the personal and corporate rates for the S Corp)

* Chart C shows that, if the full marginal tax rate for an S Corp is allowed, in order for the "business entity" to earn a full "fair after-tax return on its investment", the rate to subscribers would be slightly higher than for a C Corp

* Charts D and E show that, if income taxes are not provided as an allowance for either the C Corp or S Corp, subscribers to both would pay the same lower rate, BUT neither "business entity" would be allowed to earn a "fair return on its investment", with the S Corp earning even less of a return than the C Corp, because of the higher marginal rate for the S Corp

* The results shown on charts for S Corp's hold equally true for partnerships and sole proprietorships

III. Total After-Tax Return To Shareholders

* Tax liabilities must be compared to what net returns are created in total in order to determine what advantage, if any, would result from the absence of additional tax liabilities on some cash flows for a S Corp shareholder, because tax advantages are only valuable if they increase total returns beyond what C Corporation shareholders could obtain

* Rate regulation can never achieve, nor is it intended to achieve, parity of total after-tax returns to all shareholders, in part, because of all the, sometimes conflicting, variables that affect total after-tax return

* The Cable Act is silent as to total after-tax return to shareholders, but rather deals at the level of the cable "business entity" and its recovery of costs

* The Cable Act says nothing about any intention to over-ride S Corp related tax legislation

* Issue of total after-tax return to shareholders is very complex and involves many issues besides the tax treatment of dividends to S Corp shareholders

* Regarding even the tax treatment of dividends, many C Corp shareholders will obtain the same theoretical benefit of no "double taxation" as S Corp shareholders, or substantially reduced taxation, and the FCC does not seem concerned about the effect on subscriber rates for these situations. Further, the FCC would have to have extraordinarily complex rules if it decided to become concerned and deal with these situations by rate regulation.

* Most cable "business entities" do not pay dividends - the FCC does not appear to be concerned about the effect on C corporation rate payers in this situation

* Many cable "business entities" have never had any taxable income and, in fact, have large accumulated tax losses built up that will offset future income

* C Corp dividends are only taxable income to shareholders if they are paid out of accumulated earnings. Thus

for many C Corporation shareholders, any dividends paid to them will be treated as returns of capital and not taxable income - the same situation as for S Corporation dividends. The FCC does not appear to be concerned about the effect on C Corporation rate payers in this situation either, even though it is exactly analogous to an S corporation's position

* C Corp owner operators can pay large bonuses, in lieu of dividends, and avoid double taxation (at least up to the corporate rate). The FCC has expressed no interest in policing executive compensation through rate regulations.

* Otherwise taxable dividends paid to some C Corp shareholders will avoid full or any US income taxes and the FCC does not seem concerned about the higher rates such C Corp subscribers will pay for this theoretical tax benefit

* Dividends paid by C Corp's to tax-exempt entities (such as pension funds - major holders of public company shares) are not subject to any "double taxation"

* Dividends paid by C Corp's to corporate shareholders are subject to a dividends received deduction, lessening the effect of "double taxation"

* foreign shareholders pay little or no tax on US source income and any taxes that are paid may be allowed to be offset against their domestic income taxes due, lessening or eliminating "double taxation". Some foreign shareholders may have to pay withholding taxes on C Corp dividends, but S Corp shareholders have to pay income taxes on the cable "business entity's" net income at a rate 13.1% higher than the C Corp income tax rate - an analogous situation for the C Corp's rate payers, again that the FCC does not seem concerned about

* Dividends are paid out of available cash flow, which can be significantly different in any given year than net after-tax income or "...after-tax return...". Thus any attempt to bring the issue of dividend payments into the rate setting framework will necessarily mean mixing "apples" and "oranges" in terms of the variables involved.

* Total after-tax return to a shareholder results from the after-tax returns, if any, from dividends and capital appreciation. By concentrating on dividends the FCC will be ignoring the most important aspect of total after-tax return: capital appreciation

* Over-all capital appreciation potential of S Corp's are severely limited because of the 35 shareholder limitation

* Thus even an ordinary, passive investor in a C Corp could see enormous relative appreciation in his/her investment

because of the ability of a C Corp to raise capital and thus grow well beyond the means of any S Corp, overwhelming any tax advantage for the S Corp shareholder on his/her smaller appreciation

* With no allowance for income taxes, S Corp's will not be able to reinvest as much in the business as a C Corp would be able to and thus will not be able to see as much appreciation in the worth of its cable systems, lowering its total return, again despite the tax advantage

* Any effort by the FCC to adjust subscriber rates to reflect theoretically lower tax burdens on the S Corp shareholder, will further limit the over-all appreciation potential for the S Corp, since it will have that much less cash flow, again lowering the total return for an S Corp shareholder vs a C Corp shareholder

* Further, net after-tax capital appreciation depends on variables beyond any regulatory authority's ability to control or even offset, such as location of cable operations (high or low growth areas, proximity to number of potential purchasers), geographic concentration of cable systems, timing of sale, interest rates, credit availability, general market conditions, technological innovations (for cable and for competitive products), Telco legal status in cable, liquidity of investment (i.e. shares of publicly traded stocks vs assets of cable systems), etc.

* The point is that the FCC, through subscriber rate regulation, can not possibly control the total after-tax return to shareholders, of which theoretical avoidance of "double taxation" is only one, in reality small, aspect

Conclusion

* We are merely asking to have the allowance for income taxes treated (by use of the "gross-up" formula in Schedules A and C and inclusion of the same provision as C Corp's for cost of service showings) the same for S corporations, partnerships and sole proprietorships as for C corporations, because: (1) at least up to the corporate tax rate, the effect of income taxes on the "business entity" is the same; (2) otherwise none of these "business entities" will be able to earn a "fair after-tax return on its investment"; and (3) thereby the allowance for income taxes will have a completely neutral effect on subscriber rates as between C Corp's and the other three forms of ownership

Determination of Subscriber Rates

Chart A	Chart B	Chart C	Chart D	Chart E
For C Corp:	For S Corp:	For S Corp:	For C Corp:	For S Corp:
If Income Tax Allowance Is Made (@ 35.0% Rate)	If Income Tax Allowance Is Made (@ 35.0% Rate)	If Income Tax Allowance Is Made (@ 39.6% Rate)	If Income Tax Allowance Is NOT Made (@ 35.0% Rate)	If Income Tax Allowance Is NOT Made (@ 39.6% Rate)
= Sub' Rate	= Sub' Rate	= Sub' Rate	= Sub' Rate	= Sub' Rate
Income Tax Allowance	Income Tax Allowance	Income Tax Allowance	IncomeTax Allow'	Income Tax Allowance
Fair After-Tax Return	Fair After-Tax Return (Ex. 4.6% of Tax Rate)	Fair After-Tax Return	LESS THAN Fair After-Tax Return	Lower LESS THAN Fair After-Tax Return
Expenses	Expenses	Expenses	Expenses	Expenses

For All Examples:

Fair After-Tax Return On Investment

Investment

NOTE LOWER THAN "FAIR AFTER-TAX RETURN ON ITS INVESTMENT" FOR BOTH "BUSINESS ENTITIES" IN CHARTS D AND E ABOVE